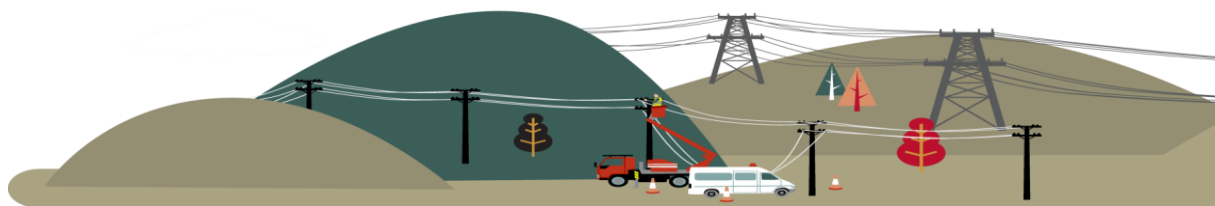


Orion New Zealand's transition to the 2015-2020 default price-quality path

Final report

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Date of publication: 7 October 2016



Associated documents

Publication date	Reference	Title
1 July 2016	ISBN 978-1-869455-21-7	Orion New Zealand's transition to the 2015-2020 default price-quality path – Draft report
1 July 2016	ISSN 1178-2560	[Draft] Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016
14 March 2016	ISBN 978-1-869454-97-5	Orion's transition to the 2015-2020 default price-quality path – Key considerations and possible approaches
28 November 2014	ISSN 1178-2560	Electricity Distribution Services Default Price-Quality Path Determination 2015 [2014] NZCC 33

Regulation Branch, Commerce Commission
Wellington, New Zealand

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Executive Summary

Purpose of this report

- X1 This report explains our decision for Orion New Zealand Limited's transition from its 2014-2019 customised price-quality path (CPP) to the 2015-2020 default price-quality path (DPP).
- X2 Unless Orion New Zealand (Orion) seeks another CPP, it will transition from its CPP to the 2015-2020 DPP on 1 April 2019. This means that Orion would only be subject to the 2015-2020 DPP for one year. The 2015-2020 DPP is generally applicable to the other 16 electricity distribution businesses (EDBs) subject to default/customised price-quality regulation.

Setting Orion's starting prices for when its CPP ends is the focus of our decision

- X3 The focus of our decision is on setting starting prices if Orion moves onto the 2015-2020 DPP when its CPP ends. In November 2014, we specified the rate of change and quality standards to apply to Orion when its CPP ends.¹

Allowable prices at the end of CPP to apply, excluding claw-back, with a CPI adjustment

- X4 Our final decision, which is unchanged from the draft decision, is to set Orion's starting prices the same as the allowable prices that apply at the end of its CPP, excluding claw-back, with a CPI adjustment.
- X5 In making our decision we are exercising our discretion under section 53X, while being guided by sections 52A and 53K. In particular, we consider that our decision would:
- X5.1 continue to provide Orion with incentives to innovate and invest (section 52A(1)(a));
 - X5.2 limit Orion's ability to extract excessive profits (section 52A(1)(d)); and
 - X5.3 reflect a relatively low-cost approach to the transition (section 53K).
- X6 We also consider that our decision is consistent with section 53P because it is based on Orion's current and projected profitability, does not seek to recover excess profits from the prior period, and is not derived from comparative benchmarking.
- X7 We thank Orion and the Major Electricity Users' Group (MEUG) for their engagement with us during this process.

¹ For more detail on the treatment of Orion in the 2015-2020 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Main policy paper" 28 November 2014, Attachment A.

1. Introduction

Purpose of this report

- 1.1 This report explains our decision for Orion New Zealand Limited's transition from its 2014-2019 customised price-quality path (CPP) to the 2015-2020 default price-quality path (DPP).

Orion New Zealand's CPP and the 2015-2020 DPP applying to 16 electricity distributors

- 1.2 On 29 November 2013, we determined a CPP to apply to Orion New Zealand (Orion) between 1 April 2014 and 31 March 2019.²
- 1.3 On 28 November 2014, we set the DPP generally applying to 16 electricity distribution businesses (EDBs) for the five-year period from 1 April 2015 to 31 March 2020 (ie, the 2015-2020 DPP). The 2015-2020 DPP specified a rate of change and quality standards for Orion, but did not determine the starting prices for Orion.³
- 1.4 Unless Orion seeks another CPP, it will transition from its CPP to the 2015-2020 DPP on 1 April 2019. This means that Orion would only be subject to the 2015-2020 DPP for one year.

Process for this decision

- 1.5 We commenced this work 36 months before Orion's CPP ends to assist Orion in making an informed choice about whether to apply for another CPP from 2019. This timeline might not be appropriate in different circumstances.
- 1.6 On 14 March 2016, we provided and invited comment on our key considerations and possible approaches for managing Orion's transition from its CPP to the 2015-2020 DPP.⁴ We received a submission from Orion and a cross-submission from the Major Electricity Users' Group (MEUG) on this paper.⁵

² *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21, 28 November 2013.

³ For more detail on the treatment of Orion in the 2015-2020 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Main policy paper" 28 November 2014, Attachment A.

⁴ Commerce Commission "Orion's transition to the 2015-2020 default price-quality path – Key considerations and possible approaches" 14 March 2016.

⁵ Orion New Zealand Limited (Orion) "Submission on Orion's transition to the 2015-2020 default price-quality path - Key considerations and possible approaches" 15 April 2016; MEUG "Cross-submission on Orion's transition to 2015-2020 DPP – Key considerations and possible approaches" 29 April 2016.

- 1.7 We published our draft decision for consultation on 1 July 2016.⁶ We received submissions from Orion and MEUG, and no cross-submissions.

Structure of this paper

- 1.8 In this paper, we explain:
- 1.8.1 our key considerations for making a decision on Orion’s transition to the 2015-2020 DPP (Chapter 2); and
 - 1.8.2 our decision on Orion’s starting prices if it moves to the 2015-2020 DPP (Chapter 3).
- 1.9 Our decision is implemented by an amendment to the 2015-2020 DPP Determination, which we have published alongside this paper.⁷

⁶ Commerce Commission “Orion New Zealand’s transition to the 2015-2020 default price-quality path – Draft report” 1 July 2016; Commerce Commission “[Draft] Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016” 1 July 2016.

⁷ *Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016* [2016] NZCC 19.

2. Key considerations

Purpose of this chapter

2.1 This chapter explains our key considerations for our decision on Orion's transition to the 2015-2020 DPP. In doing so, we also address the relevant submissions on our 'key considerations and possible approaches' paper.⁸

Summary of key considerations

2.2 In summary, we consider that:

- 2.2.1 section 53X provides us with discretion in setting starting prices in a way we judge best meets the purpose of Part 4 of the Commerce Act 1986 (the Act);⁹
- 2.2.1 section 53P is a relevant consideration for this process (ie, the starting prices we are setting are 'based on' Orion's current and projected profitability, do not seek to recover excess profits from the prior period and are not derived from comparative benchmarking);
- 2.2.1 if Orion transitions to the 2015-2020 DPP in 2019 in accordance with our decision, it will become subject to the same input methodologies (IMs) as other EDBs;
- 2.2.2 consistent with previous practice, at this stage we plan to start our process for setting the 2020-2025 DPP approximately two years before the 2015-2020 DPP expires (and as a consequence we are not currently in a position to comment on whether and how we would treat Orion's reset differently to those other EDBs); and
- 2.2.3 the IMs should not include a price-quality path transition process.

⁸ Orion "Submission on Orion's transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches" 15 April 2016.

⁹ Section 53X sets out what happens when a customised price-quality path ends: "(1) When the customised price-quality path of a supplier of goods or services ends, the supplier is subject to the default price-quality path that is generally applicable to other suppliers of those goods or services. (2) The starting prices that apply at the beginning of the default price-quality path are those that applied at the end of the customised price-quality path unless, at least 4 months before the end of the customised price-quality path, the Commission advises the supplier that different starting prices must apply. (3) The supplier remains subject to the default price-quality path until— (a) the end of the period for which it applies to other suppliers; or (b) a new customised price-quality path begins to apply to the supplier. (4) To avoid doubt, a supplier who is or was subject to a customised price-quality path may apply in accordance with section 53Q for another customised price-quality path."

- 2.3 Also, in terms of how the Incremental Rolling Incentive Scheme (IRIS) applies to Orion under the 2015-2020 DPP, our decision is that:
- 2.3.1 if Orion transitions to the 2015-2020 DPP in 2019 and subsequently onto the 2020-2025 DPP, it will start calculating amounts carried forward from the first year of the 2020-2025 DPP, which will become a recoverable cost in the following regulatory period (ie, 2025-2030);
 - 2.3.2 if Orion starts a new CPP in 2019, it will start calculating amounts carried forward immediately (ie, in the first year of that new CPP), which will become a recoverable cost following expiration of that new CPP; and
 - 2.3.3 finally, whether Orion transitions to the 2015-2020 DPP or starts a new CPP from 2019, Orion is allowed to recover the IRIS costs that are applicable under its current CPP.

Section 53X provides us with discretion in setting starting prices

- 2.4 Our view is that we have discretion in setting starting prices under section 53X, and in exercising our judgement we must do so in the manner that best meets the purposes set out in sections 52A and 53K.^{10 11} However, we consider that the section 52A purpose provides the primary objectives and considerations that we must give weight to when exercising our judgement. Orion agreed with this view.¹²
- 2.5 The price-quality path regime must operate in such a way as to promote outcomes that are consistent with those produced in workably competitive markets, such that the objectives in section 52A(1)(a) to (d) are met. In this context, a relevant consideration is the length of the DPP regulatory period still to run when an EDB transitions from a CPP (ie, one year in Orion’s circumstances).

¹⁰ Section 52A(1) sets out the purpose of Part 4: “The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services— (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and (d) are limited in their ability to extract excessive profits.

¹¹ Section 53K sets out the purpose of default/customised price-quality regulation: “the purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances”.

¹² Orion “Submission on Orion’s transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches” 15 April 2016, paragraphs 5.3, 11 and 12.

- 2.6 We should also take into account the efficiency, complexity and costs (for the regime as a whole and for EDBs in particular) in deciding how to approach our task under section 53X. The price-quality path regime should work as effectively as possible so that the costs and complexity of the process for coming off a CPP onto a DPP are no greater than necessary.
- 2.7 Finally, it may not be appropriate for the transition back to a DPP to accommodate all of an EDB's specific circumstances. The transition from a CPP to a DPP under section 53X reflects a move from the individually tailored approach of a CPP to a more generic, relatively low-cost, DPP.

Section 53P is a relevant consideration for this process

- 2.8 Our view is that section 53P is a relevant consideration for our decision-making process regarding Orion's transition to the 2015-2020 DPP. Orion supported our view.¹³
- 2.9 Section 53P sets out the process requirements for the resetting of starting prices of a DPP in terms of consultation, and prescribes certain limits on our approach. Under section 53P, starting prices are:
- 2.9.1 either the prices that applied at the end of the preceding regulatory period or based on the current and projected profitability of each EDB; and
 - 2.9.2 must not seek to recover excess profits from the prior period; and are not derived from comparative benchmarking.
- 2.10 Our view is that it is appropriate for us to apply the section 53P restrictions on setting starting prices when making decisions under section 53X. This is unless particular circumstances lead us to consider that this would be inconsistent with sections 52A or 53K.

Orion becomes subject to the same IMs as other EDBs

- 2.11 We are not directly applying any IMs in making our decision. Rather, as explained in Chapter 3, we are exercising the discretion provided by section 53X in a manner that we judge best meets the purposes set out in sections 52A and 53K.
- 2.12 However, in its submission on our 'key considerations and possible approaches' paper, Orion requested clarification on the IMs that will apply when its CPP ends.¹⁴

¹³ Orion "Submission on Orion's transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches" 15 April 2016, paragraphs 5.4, and 11-15.

¹⁴ Orion "Submission on Orion's transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches" 15 April 2016, paragraph 26.

- 2.13 We consider that when an EDB returns to a DPP, it will become subject to the DPP set previously, which may have been set under earlier IMs. The DPP does not get updated (or reset). An EDB becomes subject to the same DPP and IMs as all the other EDBs that are not subject to a CPP. Orion seems to support this view.¹⁵
- 2.14 However, a different interpretation applies in a situation where we set new starting prices at the end of the CPP (eg, using a ‘building blocks’ analysis, such as the approach used for setting the 2015-2020 DPP). In this scenario, the applicable IMs would be those that are in force when the transition from a CPP to a DPP occurs, to the extent they are relevant to setting starting prices.

DPP applying to Orion for 2020-2025 regulatory period

- 2.15 Orion explained that an important consideration for assessing whether a further CPP is required is how its price path is set for the 2020-2025 DPP.¹⁶
- 2.16 We acknowledge Orion’s views on this issue, but we have not yet begun consultation on the setting of the 2020-2025 DPP. We generally start our DPP reset process approximately two years before the current DPP expires. For instance, we started the process for the 2015-2020 DPP reset in September 2013.¹⁷
- 2.17 This decision is focused solely on the setting of Orion’s starting prices if it decides to move to the 2015-2020 DPP. Therefore, we are not in a position to provide more clarity to Orion (or to any other EDBs) regarding our possible approaches to the 2020-2025 DPP. However, our IM review draft decisions have noted that we will continue to look for opportunities to tailor the DPP, where it can be achieved without significantly increasing costs.¹⁸

The IMs should not include a price-quality path transition process

- 2.18 We do not plan to include in the IMs for CPPs any prescriptive process for the transition from CPPs to DPPs. We think that the long-term benefit of consumers is best served by providing clarity about our process outside of the IMs, enabling consideration of an EDB’s particular circumstances at the time.

¹⁵ Orion “Submission on Orion’s transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches” 15 April 2016, paragraph 27.

¹⁶ Orion “Submission on Orion’s transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches” 15 April 2016, paragraphs 24-29.

¹⁷ Commerce Commission “Proposed process – Default price-quality paths from 2015” 6 September 2013.

¹⁸ Commerce Commission “Input methodologies review draft decisions - Topic paper 2: CPP requirements” (16 June 2016), paragraphs 67-71.

- 2.19 In February 2015, we published an open letter with our proposed scope, timing and focus for the review of the IMs.¹⁹ In June 2015, we published a further paper seeking interested parties' input in identifying the key topics and defining the specific problems to be addressed by our review of the IMs.²⁰ We received submissions in August 2015, and several submissions requested us to consider developing an IM to cover the transition from CPPs to DPPs.²¹
- 2.20 The price-quality path regime represents a balance between certainty for EDBs and consumers, and flexibility for us to exercise our regulatory judgement in adjusting the regulatory controls from time to time to keep them fit for purpose.
- 2.21 The legislation is not prescriptive on the process for transition of an EDB from the CPP to the DPP, and the relevant considerations might vary on a case-by-case basis. Certainty under Part 4 is provided primarily through the IMs and through fixing a price-quality path for a set regulatory period. Flexibility is recognised in the section 53P DPP reset process, and in the CPP process.
- 2.22 MEUG submitted that the proposed timing of the Commission's decision was substantially ahead of the regular process used for setting a DPP:²²
- ...the forecasting period is much longer than usually used for a DPP reset. In a DPP reset the process starts 2 years prior to the commencement of new DPP prices whereas in this decision the Commission will decide in October this year the starting prices as at 1st April 2019, approximately 2 ½ years prior.
- 2.23 Given the particular circumstances, we considered that it was desirable to start this consultation process 36 months before Orion's CPP ends. However, a similar timeline may not necessarily be appropriate in the future for Orion or other EDBs that may transition from a CPP to a DPP.

¹⁹ Commerce Commission "Open letter on our proposed scope, timing and focus for the review of input methodologies" 27 February 2015.

²⁰ Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" 16 June 2015.

²¹ Orion "Submission on the IM Review" 21 August 2015, paragraphs 35-37; PwC "Submission to the Commerce Commission on Input methodologies review: invitation to contribute to problem definition made on behalf of 20 Electricity Distribution Businesses" 21 August 2015, paragraphs 123-124; Electricity Networks Association "Response to the Commerce Commission's Input Methodologies review paper" 21 August 2015, paragraphs 122-124.

²² MEUG "Orion's transition to 2015-2020 DPP – Draft decision" 12 August 2016, paragraph 4.

Calculation of incentive amounts for the Incremental Rolling Incentive Scheme

- 2.24 Orion's CPP contains specific rules for the calculation of incentive amounts for the IRIS.²³ These provisions were not affected by the November 2015 amendments to the IMs.²⁴ The IRIS provides a mechanism by which EDBs that are subject to price-quality regulation can retain the benefits of efficiency gains beyond the end of a regulatory period.
- 2.25 We agree with Orion's interpretation that if it moves to the 2015-2020 DPP, the DPP IRIS IMs will not apply to Orion until the next regulatory period.²⁵
- 2.26 The IMs establish that the IRIS incentive adjustment for EDBs (including Orion's future price-quality paths) is the amount determined in accordance with the formula:²⁶
- opex incentive amount + capex incentive amount
- 2.27 However, the IMs also establish that Orion does not need to calculate an opex or capex incentive amount for any year commencing *on or prior to* 1 April 2020.²⁷ Therefore, Orion will not calculate an IRIS incentive adjustment for 2019 if it transitions to the 2015-2020 DPP.²⁸
- 2.28 The IMs also set out that Orion does not need to calculate an amount carried forward for any disclosure year commencing prior to 1 April 2019. However, if Orion starts a new CPP in 2019, then it will be required to calculate amounts carried forward. These amounts then become an opex incentive recoverable cost in the regulatory period commencing after that new CPP expires.²⁹
- 2.29 Finally, whether Orion transitions to the 2015-2020 DPP or starts a new CPP from 2019, Orion is allowed to recover the IRIS costs that are applicable under its current CPP.

²³ *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21, 28 November 2013, clause 12.

²⁴ Commerce Commission "Further amendments to input methodologies for electricity distributors subject to price-quality regulation Incremental Rolling Incentive Scheme (IRIS)" 25 November 2015, paragraph 5.3 and footnote 61.

²⁵ Orion "Submission on Orion's transition to the 2015-2020 Default Price-Quality Path – Key considerations and possible approaches" 15 April 2016, paragraph 40.2.

²⁶ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 3.3.1(2).

²⁷ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clauses 3.3.2(3)(a) and 3.3.10(3)(a).

²⁸ Orion will still notionally calculate an amount carried forward in 2019, but that amount is nil. *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 3.3.3(5).

²⁹ Commerce Commission, "Electricity Distribution Services Input Methodologies Determination 2012" [2012] NZCC 26, clause 3.3.3(6)(a).

3. Our decision

Purpose of this chapter

- 3.1 This chapter explains our decision on Orion's starting prices if it moves to the 2015-2020 DPP.

Setting Orion's starting prices for when its CPP ends is the focus of our decision

- 3.2 The focus of our decision is on setting starting prices if Orion moves onto the 2015-2020 DPP when its CPP ends. In November 2014, we specified the rate of change and quality standards to apply to Orion when its CPP ends.³⁰

Allowable prices at the end of CPP to apply, excluding claw-back, with a CPI adjustment

- 3.3 Our final decision, which is unchanged from the draft decision, is to set Orion's starting prices the same as the allowable prices that apply at the end of its CPP, excluding claw-back, with a CPI adjustment.³¹

Reasons for our decision

- 3.4 As explained below, we are exercising our discretion under section 53X, while being guided by sections 52A and 53K. In particular, we consider that our decision will:
- 3.4.1 continue to provide Orion with incentives to innovate and invest (section 52A(1)(a));
 - 3.4.2 limit Orion's ability to extract excessive profits (section 52A(1)(d)); and
 - 3.4.3 reflect a relatively low-cost approach to the transition (section 53K).
- 3.5 As also explained below, we consider that our decision is consistent with section 53P because it is based on Orion's current and projected profitability, does not seek to recover excess profits from the prior period, and is not derived from comparative benchmarking.

³⁰ For more detail on the treatment of Orion in the 2015-2020 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Main policy paper" 28 November 2014, Attachment A.

³¹ In determining Orion's CPP, we decided that Orion should be allowed to claw-back \$34.8m of additional net costs incurred due to the Canterbury earthquakes over the five year CPP period. Refer: Commerce Commission "Setting the customised price-quality path for Orion New Zealand Limited: Final reasons paper" 29 November 2013, Attachment B.

Maintaining Orion's incentives to innovate and invest

- 3.6 Orion's CPP promotes the long-term benefit of consumers, consistent with the purpose of Part 4 of the Act.³² By effectively extending Orion's CPP, excluding claw-back, our decision maintains Orion's current incentives to innovate and invest. Making a decision now about our approach to Orion's transition provides Orion with certainty, which also supports a continuation of its current incentives to invest.
- 3.7 Consistent with the DPP and CPP specification of prices as specified in the IMs, our decision further maintains Orion's incentives to invest by applying a CPI adjustment, which provides an allowance for general inflationary pressure on costs.³³

Limiting Orion's ability to extract excessive profits

- 3.8 The information currently available indicates that our decision would be consistent with section 52A(1)(d). This information includes:
- 3.8.1 expenditure forecasts for 2016-2019 from Orion's latest Asset Management Plan (AMP);³⁴
 - 3.8.2 price path assessment schedules provided as part of Orion's 2015 CPP compliance statement;³⁵ and
 - 3.8.3 Orion's information for disclosure for the year ended 31 March 2015.³⁶
- 3.9 At this time, we note that Orion's latest forecasts show nominal expenditure amounts for 2016-2019 are above the assumed levels of opex and capex in Orion's CPP.³⁷ As Orion is expecting to spend more than we have allowed for in its CPP, this suggests that our decision would be consistent with section 52A(1)(d).
- 3.10 Our decision also limits Orion's ability to extract excessive profits by removing claw-back before Orion's allowable prices at the end of its CPP are 'rolled forward' by one year. Orion's allowable claw-back amount was calculated to be completely recovered over the five years of the CPP period. Therefore, it is not appropriate that this allowance is carried forward if Orion moves to the 2015-2020 DPP.

³² Refer: Commerce Commission "Setting the customised price-quality path for Orion New Zealand Limited: Final reasons paper" 29 November 2013, Attachment A.

³³ Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26, as amended, clause 3.1.1(2).

³⁴ Orion "Asset Management Plan: 1 April 2016-31 March 2026" March 2016.

³⁵ Orion "Customised Price-Quality Path Determination 2013: Compliance statement for the year ending 31 March 2015" 10 June 2015.

³⁶ Orion "Information for disclosure for the year ended 31 March 2015" 20 August 2015.

³⁷ Refer: Orion "Asset Management Plan: 1 April 2016-31 March 2026" March 2016.

- 3.11 Orion's compliance statement for the year ended 31 March 2015 shows that Orion complied with the price path in the first year of its CPP with its notional revenue (NR) being a factor of 0.992 less than its allowable notional revenue (ANR).³⁸
- 3.12 NR is calculated using current year prices and previous year quantities. Applying current year prices and current year quantities, Orion's information disclosure for the year ended 31 March 2015 shows reported actual revenue of \$156.4 million.³⁹ Dividing this figure by 0.992, we estimate 'achievable' revenue for Orion in 2014–2015 of \$157.6 million.⁴⁰
- 3.13 In comparison, the maximum allowable revenue (MAR) value for the year ended 31 March 2015 in Orion's CPP determination is \$154.8 million. The difference between this MAR value and our estimate of Orion's achievable revenue of \$157.6 million suggests that the revenue growth assumptions for the first and the prior year of the CPP regulatory period may have underestimated Orion's actual growth.⁴¹
- 3.14 For this decision, we are concerned about whether Orion's price, when its CPP ends, forms an appropriate starting point for calculating the price for 2019–2020. If the aggregate revenue growth assumptions for the CPP period are exceeded then Orion's ANR will be higher than anticipated when the CPP ends. To some extent, this risk is mitigated by the effects the excess growth may have on costs.
- 3.15 There remains considerable uncertainty about growth in Canterbury in the next few years. We note that Orion's 2016–2026 Asset Management Plan states that:⁴²
- In general, demand growth has flattened and we expect connection growth to slow over the next 2–3 years. The Christchurch CBD will continue to have growth replacement buildings and developments occurring over the next 10 years.
- 3.16 Assuming the reasonableness of Orion's expectations here, we consider that it is sufficiently likely Orion's prices for 2019–2020 will not reflect an underestimation of revenue growth.

³⁸ Refer: Orion "Customised Price-Quality Path Determination 2013: Compliance statement for the year ending 31 March 2015" 10 June 2015. Orion published its compliance statement for the year ending 31 March 2016 on 10 June 2016 and its information disclosure for the year ended 31 March 2016 is expected in August 2016.

³⁹ We calculate actual revenue as follows: Line charge revenue – Pass-through and recoverable costs – financial incentives – wash-up costs = Actual revenue.

⁴⁰ This ratio is calculated by dividing Orion's NR of \$150.2 million with its ANR of \$151.4 million.

⁴¹ Specifically, the revenue growth that would have occurred even if the nominal average price had remained unchanged from previous years, which we have referred to in the past as 'constant price revenue growth'.

⁴² Orion "Asset Management Plan: 1 April 2016–31 March 2026" March 2016, p.27.

- 3.17 We recently published a report about the impact that the first periodic adjustment to revenue limits had on the profitability of electricity distributors. Orion was excluded from the more detailed profitability analysis contained in that paper because the 2012 adjustment to the revenue limits did not apply to Orion.
- 3.18 However, our report did compare Orion's relative profitability, expenditure, and reliability, over time and with other EDBs.⁴³ This work indicated that Orion's profitability was broadly similar to other distributors from 1 April 2012 to 31 March 2015. For other distributors, the results indicated that excessive profits were limited by our adjustments to the revenue limits.

A relatively low-cost approach to Orion's transition

- 3.19 Our decision is a relatively low-cost way of managing Orion's transition to the final year of the 2015-2020 DPP.
- 3.20 Orion agreed with our approach and submitted that:⁴⁴

...the Commission's decision meets the purpose of Part 4 and balances both our interests and those of our customers by effectively extending the building block analysis that the CPP is based on by a further year (less claw-back). We also consider that this is consistent with the DPP decision to maintain the quality levels at the same levels as the final year of the CPP...

...the suggested implementation approach and the proposed methodology to calculate Orion's allowed notional revenue for 2020 using the formula outlined in clause 5 of the Draft Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016 is appropriate.

- 3.21 MEUG also agreed with our approach and submitted that the Commission:⁴⁵

...in using its discretion and reliance on Orion's forecasts has erred in favour of Orion's shareholders with expected revenues [and] hence profits expected to be higher than average...

⁴³ Refer: Commerce Commission "Profitability of Electricity Distributors Following First Adjustments to Revenue Limits: Summary and analysis" 8 June 2016. The analysis in that paper reflected the fact that the November 2012 reset occurred midway through the regulatory period, and the focus of that reset was on returns over a three-year period (1 April 2012 to 31 March 2015). In light of the circumstances surrounding the Canterbury earthquakes, we excluded Orion from the scope of our November 2012 decision to minimise consultation obligations on the business. We therefore did not develop forecasts in the same way for Orion as for other distributors.

⁴⁴ Orion "Submission on Orion's transition to the 2015-2020 default price-quality path – draft report" 12 August 2016, paragraphs 4 and 6.

⁴⁵ MEUG "Orion's transition to 2015-2020 DPP – Draft decision" 12 August 2016, paragraph 3.

3.22 MEUG also considered that:⁴⁶

a pragmatic approach is needed given the very difficult circumstances faced by customers of Orion post the earthquakes and uncertainty on the shape and rate of demand for network services. Hence this *1 year DPP does not warrant a full building block analysis* (emphasis added).

3.23 We accept that there could have been potential benefits of adopting a ‘full building blocks’ approach to setting Orion’s starting price for when its CPP ends. However, the DPP/CPP regime should work as effectively as possible, so we have taken into account efficiency, complexity and cost in making our decision.

3.24 Our view is that part of working effectively is that the costs and complexity of the process for coming off the CPP on to the DPP should be kept to a minimum. This applies for the regime as a whole and for suppliers in particular.

3.25 Given that Orion would be subject to the 2015-2020 DPP for only one year, we consider that the benefits of adopting a more detailed approach in the particular circumstances are unlikely to outweigh the costs. Submitters supported this approach.

3.26 MEUG is concerned that:⁴⁷

...in the future other CPP applicants might presume a similar treatment for the transitional year(s) DPP between the end of a CPP and the DPP set at the start of the next full Regulatory Control Period (RCP).

3.27 As stated in Chapter 2, our view is that the approach taken to a CPP/DPP transition should be dependent on the particular circumstances facing an EDB and its consumers. It is therefore appropriate to make CPP/DPP transition decisions on a case-by-case basis.

3.28 In circumstances where an EDB transitions from a CPP to a DPP earlier in a regulatory period, a different approach (eg, using ‘building blocks’ analysis) to set starting prices may better promote the purpose of Part 4 and section 53K.

3.29 We encourage EDBs subject to a CPP to engage with us about their transition to a DPP so that:

3.29.1 we can make a timely decision about how to approach a transition given an EDB’s particular circumstances; and

3.29.2 an EDB can make an informed decision about whether to apply for another CPP.

⁴⁶ MEUG “Orion’s transition to 2015-2020 DPP – Draft decision” 12 August 2016, paragraph 5.

⁴⁷ MEUG “Orion’s transition to 2015-2020 DPP – Draft decision” 12 August 2016, paragraph 5.

Our decision is based on Orion’s current and projected profitability

3.30 We set the prices for Orion’s CPP based on its current and projected profitability. Our decision is to set Orion’s starting prices the same as the allowable prices that apply at the end of its CPP, excluding claw-back, with a CPI adjustment. Therefore, our view is that those prices are also based on current and projected profitability. We also consider that our decision is consistent with sections 52A and 53K.

Implementation

3.31 Alongside this paper, we have published an amendment to the 2015-2020 DPP Determination, which shows how we will implement our decision.⁴⁸ The amendment determination is unchanged from the draft published for consultation on 1 July 2016.

3.32 The amendment provides a formula in Schedule 3B for calculation of Orion’s ANR for 2019-2020 if Orion transitions to the 2015-2020 DPP. Key points to note are that the formula:

3.32.1 excludes claw-back; and

3.32.2 has an ‘X-factor’ of 0%.

3.33 To implement our decision, we have not set Orion’s starting price for 2019-2020 by specifically determining a value for its MAR. Instead, our amendment determination enables the allowable prices that apply at the end of Orion’s CPP, excluding claw-back, to be ‘rolled forward’ by one year with a CPI adjustment.

3.34 On 2 June 2016, we received a letter from Orion that provided a suggestion for amending Schedule 3B of the 2015-2020 DPP Determination.⁴⁹ Orion suggested that its ANR for the assessment period ending in 2020 should be calculated in accordance with the following formula:

$$ANR_{2020} = \left(\sum_i P_{i,2019} Q_{i,2018} - (K_{2019} + V_{2019}) + (ANR_{2019} - NR_{2019}) - \text{Clawback} \right) (1 + \Delta \text{CPI}_{2020}) (1 - X)$$

3.35 Orion suggested that the amount of claw-back to be deducted from its ANR for 2020 should be one-fifth of \$34.8 million (\$34.8 million being the total amount of claw-back that we determined Orion should be allowed to recover during its CPP).⁵⁰

⁴⁸ *Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016* [2016] NZCC 19.

⁴⁹ Orion “Orion’s transition to the 2015-2020 default price-quality path – suggested approaches” 2 June 2016.

⁵⁰ Commerce Commission “Setting the customised price-quality path for Orion New Zealand Limited - Final reasons paper – [2013] NZCC 21” (29 November 2013) at Attachment B.

3.36 However, when Orion’s CPP was determined, claw-back was applied as part of Orion’s MAR (\$638.3 million in total). This means that the actual amount of claw-back that Orion recovers in each year of its CPP increases each year with CPI, market growth, and an X-factor, and can only be known at the end of an assessment period. Our amendment is designed to ensure that a consistent approach is taken when claw-back is removed from Orion’s ANR for 2020.

3.37 Therefore, as set out in the amendment to the 2015-2020 DPP Determination, our view is that Orion’s ANR for 2020 should be calculated in accordance with the following formula:⁵¹

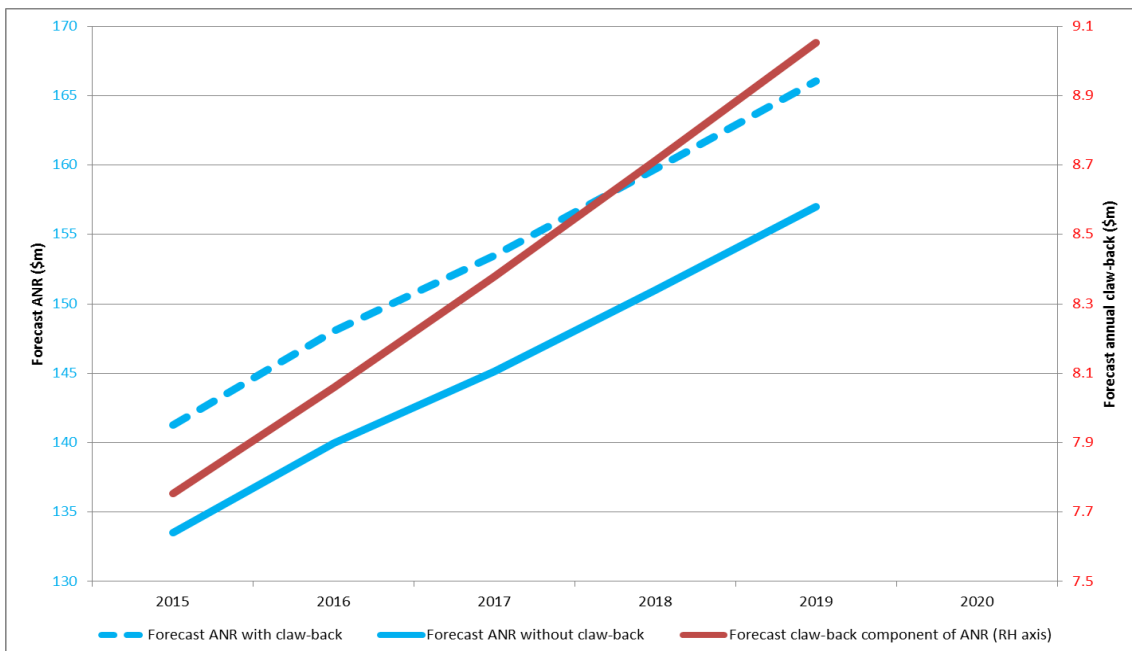
$$ANR_{2020} = E \times \left(\sum_i P_{i,2019} Q_{i,2018} - (K_{2019} + V_{2019}) + (ANR_{2019} - NR_{2019}) \right) \times (1 + \Delta CPI_{2020}) \times (1 - X)$$

where:

E is the 2014–2019 claw-back exclusion ratio, being equal to $\frac{638.3 - 34.8}{638.3}$

3.38 As shown below in Figure 3.1, claw-back amounts are a fixed proportion of the price path in Orion’s CPP. Accordingly, the estimated claw-back amount shown Figure 3.1 grows as the CPP regulatory period progresses.

Figure 3.1 – Forecast ANR and forecast claw-back for Orion’s CPP



⁵¹ *Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016 [2016] NZCC 19.*

- 3.39 Therefore, rather than specify an amount to be deducted now, we consider that it is appropriate to apply a ratio approach when removing Orion's claw-back from a 'roll forward' of prices in the last year of its CPP into 2019-2020. We consider that our amendment determination achieves this.